

Investment Commentary

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Past performance does not guarantee future returns.

Market and Performance Summary

During the first quarter of 2007, the equity portion of the accounts managed by KIG, in aggregate, was down 0.7% (net of fees), below the S&P 500's return of a positive 0.6%. Our performance since inception, a period now covering ten and one-quarter years (12/31/96- 3/31/07), remains well ahead of our benchmark. On an annual basis over this period, the KIG composite has returned 14.3% (net of fees) versus the 8.3% earned by the S&P 500.

In January, Jeremy Grantham of investment firm GMO wrote in his letter to investors, "Such a tidal wave of easy, cheap borrowing coupled with a Goldilocks economy has created an attitude toward risk unlike anything seen before. From this happy, seemingly risk-free level, how easy it must be to have an unpleasant surprise." At the time, we're sure many viewed his missive with disdain - why do anything to remove the punch bowl from such a swinging party? As we now know it turned out to be quite prescient.

Only a month or so later, just when things seemed relatively calm in the global markets they became calm no more. Influenced by a 9% drop in the overheated Chinese markets and a plunge in U. S. durable goods orders, the market tumbled about 5% at the end of February. Market participants seem to always need a reminder (mainly violent) that markets do not go straight up. As has happened throughout history, eras of low volatility and general prosperity are often followed by periods of disturbingly high volatility. We have and continue to position our portfolios with these types of thoughts squarely in mind.

Because of this volatility, some may recall last quarter as a risky time to be an equity investor. We're not so sure. We tend to think about risk in more practical terms - to us, risk is the chance of experiencing a permanent loss of capital. We don't subscribe to the camp that considers risk as volatility, or the up and down nature of the markets. For us, volatility is more synonymous with opportunity. When stocks fall (rise) for non-fundamental reasons, it may enable us to buy (sell) the same company that just the day or week before was deemed to be too expensive (cheap). In reality, under these assumptions the only thing that has changed is its price. We've been through many periods like the last quarter and have come to expect these types of corrections. We view them as normal course - it's what markets do. It may be daunting, but it's not necessarily risky.

If the market continues to falter it is unlikely that we will be selling into it, rather we will use it opportunistically.

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cally to bulk up on companies we've followed for years but always deemed too expensive. After all, you should want to buy something when it is cheaper. This takes an extreme amount of discipline because it's the opposite of what most people tend to do. It sounds straightforward to want to buy something after it's gotten cheaper – like buying things at your favorite store after they go on sale. But somehow with stocks, people view it differently. Perhaps it's because the painful feeling of loss far exceeds the satisfaction of a gain. This very human trait makes it extremely difficult for investors to embrace what has recently fared poorly, and it creates tremendous opportunity (for us).

We attempt to keep our mindset the same regardless of the environment. Investing is always about getting the appropriate value for the price paid. As Seth Klarman of the Baupost Group stated in a recent post, "Investments come in the following varieties: undervalued, fairly valued, and overvalued. Price is everything, and every investment is undervalued at one price, fairly valued at a higher price, and overvalued at some still higher price. You buy the first, avoid the second, and sell the third." It really shouldn't be any more difficult than that and we always try to keep that in perspective.

Prices should only inform investors not influence them. And we know in our hearts that the best time to invest is when things you love are going lower. It's just not a natural act so you need to develop the discipline to do it. We love it when businesses go on sale. Oddly enough, many investors don't - which is why we feel confident in our continued ability to consistently outperform over periods longer than a quarter or two (or three), mind you.

Loss and Recovery

To put the above discussion about risk equating to permanent loss of capital in perspective (and not short-term mark-to-market variability in price), we thought it would be helpful to use actual results from our audited record. As was the case recently, our clients are not immune from experiencing dips in their asset values from time to time. Our single worst period in our ten-plus year history saw our composite portfolio fall by 29% (our maximum drawdown) from peak to trough. However, the recovery period was relatively quick as all of these losses were recovered over the subsequent 11 month period (from February 2003 to January 2004) and our portfolio has generally been making new highs since. Not sounding pleasant? Well, in com-

parison to our benchmark it's downright bliss. During the same time period, the S&P 500 experienced a maximum drawdown of 45% and took over four years (49 months) to recover.

So we lost over a third less and took one quarter of the time to recover. This is probably the single biggest factor as to why our results have been over 70% higher than the S&P 500 over this period (14.3% annualized vs. 8.3%). It's also why we care so much about investing with a margin of safety.

The Retail Trade

At KIG, we have a "generalist first, industry specialist second" approach to investing. And while our strategy is very well defined, it's also very broad. From a big picture standpoint, our experience in analyzing businesses has taught us what characteristics tend to be shared by successful businesses. In other words, we know what a good business looks like and pretty much ignore those that don't measure up to these standards. Having built from the ground up, a large universe of high quality businesses, we are very comfortable investing in a multitude of industries enabling us to build diversified portfolios.

However, we have a propensity to focus broad swaths of our portfolio in sectors where we feel we have a particular edge. One such sector which we feel is firmly in our circle of competence is consumer oriented companies where brand equity is the single biggest competitive advantage. Brand names like **Coca-Cola (KO)**, Apple, Starbucks, Gillette, Nike, and **Walt Disney (DIS)** are just a short list of some of the most dominant. Positive brand identity implies a well-known image established through name recognition and conveys some sort of added value to the product or service beyond the functional benefits provided. It connotes the value a consumer places on the product or service and encompasses everything that a consumer thinks, feels, and knows about the product or service. A good brand is therefore a powerful asset and we believe companies that own them can be highly rewarding investments (assuming they're bought at the right price).

A sub-category of the consumer sector where we feel we've built up specific expertise is in retail. Retailers can either sell their own proprietary products (Ann Taylor, Coach, Cheesecake Factory) or other manufacturers' products (Best Buy, T.J. Max, Barnes & Noble). A more recent trend is for a retailer to pursue a hybrid approach through the sale of private label (proprietary) products along side non-proprietary products (**Costco (COST)**, Federated, Safeway). Regardless of the methodology, building

a brand image is usually paramount to success in retail. For instance, the **Wal*Mart (WMT)** name connotes low prices. **Abercrombie & Fitch (ANF)** promotes an image of casual luxury. And Neiman Marcus signifies upscale and expensive.

Developing a brand is important, but execution of the concept may be even more so. In a sense, brand gets them in the door, but execution keeps them coming back. Retail level execution encompasses a myriad of details, including product assortment and placement, inventory management and logistics, and customer service to name just a few.

Based on our years following the retail industry (reading, examining financial statements, and, yes, shopping), we feel that we have pretty much figured out who has the most influential brand names and which companies execute well. So when we are looking at a retailer for potential investment it is a given that these two traits are evident. What we mainly focus on then (besides price) is the capital allocation skills of management. When done properly, allocation of capital can drive the bulk of shareholder value. With a poor capital strategy, the brand can become diluted and the execution pressured, leading to lower profitability and returns.

We believe that a “best in class” retail company must maintain a proper balance between debt and equity, and pursue a prudent level of unit growth (growth capital expenditures) while keeping up with maintenance capital requirements. At the same time, it is extremely important to keep the concept relevant to the consumer. This puts a premium on spending initiatives within the four walls of the store (such as décor, presentation of product, remodeling activity, expansion) to drive incremental customer visits which is critical to the overall health and perception of the concept. If there is any cash left over, returning it to shareholders should be a top priority.

A common mistake that retailers make is an overly optimistic view on the long-term prospects of a given concept. This may lead to excessive and unnecessary capital expenditures ultimately eroding shareholder value. The root cause of overly optimistic management stems from companies trying to maintain “Wall Street” projections. As a result, over the years, we have seen a significant increase in companies with multiple concepts trying to increase their geographic presence. In most cases, this leads to significant increase in capital expenditures or using their balance sheet to make acquisitions. This does not usually have a good ending. The point being that what might appear good for a company (or a stock) in the short term might not always benefit the company in the long-term.

We have witnessed, more often than not, a retailer maintaining an accelerated rate of new unit growth thus putting significant pressure on the organization. There are three primary ways we often see this pressure manifest. First, the real estate division, whose sole purpose is to find quality locations invariably compromises its standards in order to satisfy guidance the company has given Wall Street. After a few years of compromises, sales in the new units begin to suffer and the company misses the targeted return hurdles. Second, the company cannot hire enough qualified managers and/or there is not enough time to properly train them resulting in underperformance at the new units. And third, the concept was not properly conceived and/or ill-timed and cannot compete in the highly competitive retail industry.

We have also seen companies slow new unit growth to focus on their core businesses. The implication of this is also significant for shareholders as the company will likely see a significant increase in its operating performance and its return on invested capital. This is a result of increased sales at the existing stores while investing less capital in unprofitable stores in mature businesses or markets. Ultimately, free cash flow generation becomes significant and capital can be allocated to share repurchases, debt pay down or an increase in dividend payments. As we scour the universe of the retailers we look for companies either currently exhibiting these characteristics or where the company should be considering it imminently.

McDonald’s (MCD) (restaurants are just a specialty retailer, in our view) is one example of where a change in capital allocation strategy was the primary catalyst in the company’s turnaround beginning in 2003. One rule of thumb is that when a concept is having operational issues (as McDonald’s was) it is very hard to add new units (as McDonald’s was) to the system and have them reach the target return objectives. McDonald’s was slow to adjust to this reality and its allocation of capital became imprudent and careless. We laid out our plans for reform for McDonald’s in our Spring 2003 newsletter when we wrote:

“...as shareholders who eventually want to see more distributable cash in our pockets, the current capital allocation is not ideal. Of the \$2 billion spent in 2002 we estimate that \$500-\$700 million was spent on maintaining and improving the current restaurant base (good use). The balance, approximately \$1.3-\$1.5 billion was spent on the construction of new stores (bad use). There’s no mandate that states McDonald’s must grow its store base or acquire new restaurant concepts, and given its current situation, we argue its mandate should be not to grow,

and possibly even to shrink its store base. We believe the company should cull unprofitable locations and exit all markets that don't continue to make strategic sense. Cash that would have been plowed into store base growth can instead be used to continue to shrink the company through accretive share buybacks or possibly an increase in the dividend."

A new management team was ultimately brought in and while lip service was given to shoring up operational issues one of their first major acts was to announce a capital allocation strategy similar to what we prescribed. Soon after the capital plan was announced, store traffic began to rise, same store sales stabilized and then rose, and operating margins increased. New products (salads, McGriddles, among others) certainly helped, but the fact that the new strategy instilled fiscal and operational discipline that enabled McDonald's to return approximately \$10 billion to shareholders in the form of share repurchases, dividends and debt repayments was, in our view, as big a factor as any in the stock's nearly 200% subsequent rise.

Our investment theses for current holdings **Wal*Mart (WMT)**, **Home Depot (HD)** and **Gap (GPS)** rests largely on their ability to execute similar capital allocation strategy shifts. In fact, each of these companies has begun laying the groundwork for moving down this path.

CEO Shuffle

It was a bad quarter to be a CEO, particularly if you ran one of the companies held in the KIG portfolio. In rapid succession, CEOs of three of our core holdings (Home Depot, Gap and **Dell (DELL)**) were summarily dismissed. Each situation came with its own unique circumstances and we do not feel it caused any impairment of our investment theses. Rather, we are encouraged about the future paths of these companies.

So how then do we reconcile our belief that strong management is generally a key characteristic of our investment criteria? We are reminded of a quote from Peter Lynch who famously suggested that one should "Go for a business that any idiot can run – because, sooner or later, any idiot probably is going to run it." Now, we are not suggesting that any of these guys are idiots, far from it. But the lesson is an important one. As far as ranking our investment criteria, the economics of the business trumps management any day of the week. Managers come and go but the fundamental characteristics of great businesses remain consistent over time. In fact, good managers are unlikely to triumph over bad businesses so it is more important to get the

business right than the management.

A quick review of each situation is discussed below. If there is a commonality it's that we are buying the earnings power of the business, not the personalities running them.

Bob Nardelli, Home Depot: Most of the negativity surrounding Nardelli was due to two things - Home Depot's poor stock price performance since Nardelli took over and his huge compensation package. In our view, timing was more the culprit than Nardelli's performance as CEO. We feel he made important contributions (centralizing processes, implementing technology systems) in moving Home Depot from its entrepreneurial roots to the retail behemoth it has become. He couldn't help the fact that he happened to join the company when it was trading at a ridiculously high valuation (50x earnings). Sales and earnings more than doubled under his watch, but gravity took hold of the excessive valuation and the price/earnings multiple compressed. However, some criticism is warranted. He was an autocrat, alienating managers, lower level employees and shareholders alike. His arrogance culminated at the 2006 shareholders' meeting where as the only board member present he did not give the customary speech and took no questions from the audience. His successor, Frank Blake, has already showed how things will change at the top. His very first actions were to reach out to both employees and shareholders and he has already demonstrated a willingness to listen to the views of others.

Paul Pressler, Gap: We had long viewed Pressler as somewhat of a fish out of water at Gap. Pressler made a name for himself while at Walt Disney where he successfully led the theme park division - not a standard training ground for heading up one of the largest apparel companies in the world. Initially his appointment worked out well as he was able to instill the financial discipline that was sorely lacking in the prior management team. He focused on improving profitability and restoring balance sheet health, and by any definition, was wildly successful. But once that was accomplished and the focus needed to turn to fashion, he fell flat and was never quite able to restore Gap to its former icon status. Robert Fisher, son of Gap founder Donald Fisher, has taken over on an interim basis as the board looks for the next phase of its leadership.

Kevin Rollins, Dell: Rollins may have been the right guy but it was just the wrong time. Facing a slowing technology upgrade cycle, a renewed competitor in Hewlett Packard, and with the benefits of its direct-sales model shrinking, Dell lost its once huge lead in productivity and efficiency. We're not sure if any

one else could've done better. Founder and once golden boy, Michael Dell, has resumed his leadership role but we believe it will take time to implement changes necessary to restore Dell to its former glory.

Each of these reminds us more than vaguely of McDonald's in 2002, which replaced its then CEO at a time when the company seemed to be floundering (chronicled above). Sometimes current leadership can make the tough decisions necessary to further shareholder value. Sometimes you need new blood.

Contrarianism Redux

"The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone agreed about its merits, the investment is inevitably too dear and therefore unattractive." - John Maynard Keynes

As dedicated contrarians, no sweeter words could ever be spoken. As you know, our long held belief is that it's impossible to produce superior performance unless you do something different from the crowd. Don't despair - we're not going to launch into another diatribe about the merits of contrarian investing. However, after reading the May 2005 study "The Price of Conformism" (by Dasgupta, Prat and Verardo) we just couldn't let it go without remark. The gist of this beautifully titled study is that stocks that have been persistently sold by institutions outperform stocks that have been persistently bought by them, over a period of at least two years in the future. Not a screaming endorsement of the supposed "smart money". So what could explain these counterintuitive results? Not surprisingly it comes down to incentives and the behavior those incentives create.

The authors put forward the argument that a manager continually faces tension between his/her desire to maximize expected profit and his/her reputational concerns, which make him/her want to pretend his/her signal is in accordance with those of others. Assume a certain manager has a negative bias toward a particular stock. If, for instance, he/she observes that many managers have recently bought the asset, this manager with the negative signal is reluctant to sell because he/she realizes that his/her negative signal is in contradiction with the positive signals observed by his/her colleagues. Selling would therefore likely to appear as if he/she is out of step to his/her investors. Conversely, a manager with a positive bias would be even more willing to follow his/her signal after seeing a

sequence of buys, because his/her profit motives and his/her reputational incentive go in the same direction.

The consequence of these actions is that stocks become mispriced and is the cause of the underperformance. Stocks that have been persistently bought/sold at prices that are higher/lower than their fair value lead to a correction when the true value is revealed.

This does not come as a surprise to us. It's the same old circular logic that we've seen prevail on Wall Street for years. Stocks that go up continue to go up and stocks that go down continue to go down, until they don't. The interesting thing that this study brings to light is that it's not just individual investors that succumb to this behavior but the big boys as well.

In our opinion, these results are not necessarily an indictment of the skill level of institutional money managers but of the behavioral tendencies they exhibit brought on by the incentive structure under which they operate. A focus on the short-term is the key stumbling block. These managers, in search of higher short-term returns, sell without regard to the real opportunity cost of what they are giving up over the long-term. And they buy without regard to the value they are receiving. They may sell high quality businesses with great cash flows which may represent some of the most undervalued equities in the marketplace and invest in things that are of lesser quality but for whatever reason may have shorter term upside.

Just another data point that enforces our belief in the way we operate.

Portfolio Activity

We were fairly active during the quarter, taking advantage of the volatility to establish initial positions in six companies that met our valuation criteria. Unfortunately, none of these were so persuasively cheap that they caused us to act in a big way. In other words, we were content to take a small position now and are prepared to make it more meaningful on further price weakness. Companies purchased were **Adidas (ADDDF)**, **Carter's (CRI)**, **Cintas (CTAS)**, **Joy Global (JOYG)**, **Limited Brands (LTD)**, and **Quest Diagnostics (DGX)**.

We were somewhat active on the selling front as well. This was due partly to make good on our promise made last quarter to slim down the ranks of the portfolio and restore a greater sense

of concentration but primarily to create room in the portfolios for the new positions. Because we work with a finite amount of capital, we must make (sometimes) difficult decisions about what to sell in order to accommodate new ideas. These capital allocation decisions are based solely on what we think has the best risk/reward characteristics. During the quarter we eliminated positions in **Abbott Labs (ABT)**, **Abercrombie & Fitch (ANF)**, **Assurant (AIZ)**, **Clear Channel (CCU)** (tax deferred and long-term capital gain positions only), **Foot Locker (FL)**, **Gannett (GCI)**, **Kohl's (KSS)**, and **Schering Plough (SGP)**. We trimmed our exposure to **Gap (GPS)**, **Hewitt (HEW)** (tax deferred only), **McDonald's (MCD)**, **US Bancorp (USB)**, and **Walt Disney (DIS)**.

Reviewing the buy side, we purchased shares of Carter's, the baby and young children's apparel retailer and wholesaler. The company has many of the attributes we mentioned in the above discussion on the retail industry, particularly brand equity. The company's solid stable of kid's clothing brands and multiple distribution channels provide it with an advantage in a competitive industry. We believe management's capital allocation skill is decent and their 2005 acquisition of OshKosh will provide a good return on their investment. Valuation became reasonable when management forecasted flat same store sales growth in 2007 - a clear sell signal to many investors. Not to us. We take a longer term view (i.e. beyond just this current year) and perceive Carter's issues on the retail side of the business as just part of the inevitable hiccups all businesses experience. We also feel that investors are overlooking the powerful economics and future opportunities of the company's wholesale business, primarily their two lines developed exclusively for Wal*Mart and Target.

That said, some client accounts that normally would have received an allocation did not receive shares of Carter's. This was an unintended consequence of our sensitivity to price coupled with less than optimal liquidity in trading volume. Typically, when we put in a buy order with our trading desk we give them a dollar limit of which they may not exceed. On the day of purchase, shares of Carter's rose above our set limit and no further shares were purchased. Because of this we did not receive the total number of shares necessary to do a full allocation. When this situation arises, which is rare, we perform a random lottery of all participating accounts and work our way from top down allocating the actual shares purchased. The following day, we then attempt to fill the remaining shares. In this case the shares did not fall to our limit and we were unable to complete the order. Don't despair. Be confident that the discipline we employ in the process has benefitted you in the past and will continue to do so in the future.

We ventured into adult fare as well - Adidas, the German designer of athletic shoes and apparel and Limited Brands (intimate apparel through its Victoria's Secret concept and personal care and beauty products through Bath & Body Works). Both of these companies possess outstanding brands but had traded to levels more apt for mediocre to below average companies. While the market is focused on Adidas's controversial Reebok acquisition, we feel the risk of management distraction and a lengthy turnaround effort are more than priced into the shares. Similarly, Limited's troubled namesake retail stores are obscuring the underlying value of Victoria's Secret and Bath & Body Works. Even assuming the Limited stores are worthless we get a business value substantially above current levels.

Non-consumer related purchases included Cintas, Quest Diagnostics and Joy Global. Cintas is primarily in the business of uniform rentals and possesses a sizeable moat versus its undercapitalized, fragmented competition, and possesses the cash flow generating characteristics we love. Quest Diagnostics, (which you may recall we've owned before) is a provider of diagnostic testing services to the healthcare industry. They operate with only one major competitor (recall oligopoly structure discussion from last quarter's letter) in an industry that enjoys favorable economics and decent growth prospects. Recent concerns center on a major contract loss that will dent current year's earnings growth. Looking out further, however, we see Quest returning to growth mode and continuing to generate large amounts of free cash flow. Free cash flow is also at the core of our affinity for Joy Global, a leading maker of high productivity mining equipment. Joy enjoys an extremely strong competitive position as evidenced by the large market share held by most of its products. Another positive aspect is that it generates over 60% of its revenues from servicing and providing spare parts to its large installed base. This after-market revenue is very stable and offsets a great deal of the impact that any declining commodity cycle may inflict to its original equipment.

Wealth Planning Capabilities

As some of you already know, over the last few years, KIG has been building up our resources in the broader areas of financial planning - both in terms of people and technology/infrastructure. We now have four people on staff that, in total, have over 50 years of financial planning experience - three of whom are Certified Financial Planners (CFP®). In fact, to the best of our knowledge, we are the only firm in the Chicago area that has two professionals who have been named as Top Wealth Advisors in the country by Worth Magazine.

More importantly to our clients, however, it means that if you need advice with broader issues, we can often help.

- When can I retire?
- How much can I spend in retirement?
- How can I invest my 401(k) or assets that are held elsewhere to complement my KIG portfolio?
- I know that I should be doing something more as it relates to estate planning. Can you give me an overview of what I should be thinking about?
- What are my different options for saving for my kids' (or grandkids') college education? Are 529 plans right for me?
- How do I figure out what my minimum distributions are supposed to be from my IRA now that I am approaching age 70 1/2?
- I am self-employed. I've heard of so many different types of retirement plans that I can set up (Keoghs, Profit Sharing Plans, defined benefit plans, defined contribution plans), can you help me figure out what type of plan is right for me?

We could go on and on. But we suspect that you get the point. If you have a question, ask your portfolio manager. Our goal remains to be our clients' most trusted adviser. If you have opinions as to how we're doing in that regard, we'd love to hear from you.

Please Join Us In Welcoming...

Mary Anderson joins KIG as a Portfolio Manager where she focuses on the construction and maintenance of client portfolios. With over 25 years working in the financial markets and vast experience advising high net worth individuals in the area of wealth management, Mary adds depth to KIG's ability to provide comprehensive advisory services to our clients.

Mary comes to KIG from Harris Bank where she was Vice President and Senior Portfolio Manager at Harris Private Bank in Lake Forest. Mary joined Harris's Private Bank in 1995, and specialized in developing asset management programs for large complex trusts and investment relationships. Mary came to the Private Bank from Harris's Treasury where she was one of the original members of the Risk Management team and later advised corporate and institutional investors. She joined Harris in 1984 from Continental Bank's Investment Department.

Mary graduated with a bachelor's degree from Marquette University and an MBA from the Carlson School of Manage-

ment at the University of Minnesota with a concentration in finance. She also earned an MA from the University of Wisconsin – Milwaukee.

Jenny Simmons joins KIG as a Portfolio Manager where she focuses on the construction and maintenance of client portfolios as well as client financial planning. Jenny's financial planning background further deepens KIG's ability to provide comprehensive investment advisory services to our clients. Jenny comes to KIG from RSM McGladrey, Inc. and Deloitte & Touche, LLP where she provided comprehensive financial planning advice to senior corporate executives and high net worth individuals and families.

Jenny received her Bachelor of Science in Accounting with a Minor in Finance from Northern Illinois University, graduating summa cum laude. She also earned her Master's of Accounting Science with an area of specialization in taxation from her alma mater. Jenny is a licensed CPA in the State of Illinois.

Carin Nesbitt joins KIG as an Associate in our operations department and is responsible for our portfolio management and reporting systems, and provides support to our Portfolio Managers. Carin has over 17 years of experience in the investment industry where her roles have included both operations and client service. Carin comes to us from Frye Louis Capital Management and Northern Trust.

Quotes

"Six or seven years ago, buying value meant getting a price discount. Today, that means getting a quality premium for free. Value investing used to be about getting a price cushion by buying average companies for way below average prices. Today, the cushion comes from buying quality businesses for the price of average businesses." Bill Nygren, Oakmark Fund

"Buy low sell high is a fairytale. Buy high and sell higher is how to make mad money!" - Jim Cramer of CNBC's "Mad Money" (We just can't tell you how much we love hearing this type of talk.)

"We like to think that seeing is believing, but seeing is believing what the group tells you to believe." - Dr. Greg Berns, psychiatrist



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